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Supreme Court of the United States
OCTOBER TERM, 1997

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, PAINEWEBBER INCORPORATED, and DEAN WITTER REYNOLDS INC.,
Petitioners,

v.

JEFFREY PHILLIP KRAVITZ, GLORIA BINDER, and BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Petitioners are registered broker-dealers that make markets in over-the-counter securities, trading for their own accounts with their customers. During the class period alleged in this case, the staff of the Securities and Exchange Commission, petitioners' primary regulator, stated that a broker-dealer's "duty of best execution" of customer market orders is satisfied by "executions * * * based on the NASDAQ national best bid or offer [the 'NBBO'] * * * absent customer instructions to the contrary." Execution of small retail orders at the NBBO was also virtually universal industry practice. Nevertheless, the en banc Third Circuit ruled in this case that a broker-dealer's duty of best execution requires it "to maximize the economic benefit to [its customer]" and that a broker-dealer that routinely executes small customer orders at the NBBO may have violated SEC Rule 10b-5 unless it has affirmatively disclosed to its customer that it will not seek better prices. The questions presented by this ruling are:

1. Whether a broker-dealer that makes no false statement, obeys all customer instructions, and routinely executes small retail orders at the NBBO in accordance with SEC guidance and virtually universal industry practice can be found to have acted with "scienter" as defined in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), because it did not seek better prices for the customer.

2. Whether, if a broker-dealer has a fiduciary duty to customers to seek out better-than-NBBO prices, its failure to seek out such prices can be bootstrapped from a breach of fiduciary duty into fraud, notwithstanding *Santa Fe Industries* v. *Green*, 430 U.S. 462 (1977), simply by alleging that the firm failed to disclose that it would not seek out such prices.

3. Whether, under the "shingle theory," a market maker has an obligation, in determining prices, "to maximize the economic benefit to the [customer]" rather than merely comply with all laws, all SEC regulatory requirements and guidance, and general industry practice.

RULE 29.6 STATEMENT

The following are the parent companies or nonwholly owned subsidiaries of the petitioners:

The parent of petitioner Merrill Lynch, Pierce, Fenner & Smith Incorporated is Merrill Lynch & Co., Inc. Merrill Lynch, Pierce, Fenner & Smith Incorporated has no nonwholly owned subsidiaries.

The parent of petitioner PaineWebber Incorporated is PaineWebber Group Inc. PaineWebber Incorporated has no nonwholly owned subsidiaries.

The parent of petitioner Dean Witter Reynolds Inc. is Morgan Stanley Dean Witter & Co. Dean Witter Reynolds Inc. has no nonwholly owned subsidiaries.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners Merrill Lynch, Pierce, Fenner & Smith Incorporated, PaineWebber Incorporated, and Dean Witter Reynolds Inc. respectfully petition for a writ of certiorari to review the decision of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The en banc opinion of the Third Circuit is reported at 135 F.3d 266 and reprinted at Pet. App. 1a to 16a. The vacated panel opinion is reprinted at Pet. App. 17a to 36a. The opinion of the district court is reported at 911 F. Supp. 754 and reprinted at Pet. App. 37a to 79a. An earlier opinion of the district court is unreported, and is reprinted at Pet. App. 81a to 87a.

JURISDICTION

The judgment of the court of appeals on rehearing en banc was entered on January 30, 1998. This petition is timely filed pursuant to 28 U.S.C. § 2101(c) and Sup. Ct. R. 13. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTE AND RULE INVOLVED

Section 10(b) and SEC Rule 10b-5 are set out at Pet. App. 91a and 92a, respectively.

STATEMENT

This Court has repeatedly sought to confine the judicially created cause of action under SEC Rule 10b-5 to cases of actual fraud. *E.g.*, *Chiarella* v. *United States*, 445 U.S. 222, 234-235 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud"); *Central Bank* v. *First Interstate Bank*, 511 U.S. 164, 177-178 (1994); *Dirks* v. *SEC*, 463 U.S. 646, 666 n.27 (1983); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 733 (1975). In particular, the Court has held that Rule 10b-5 applies only if the defendant acted with "scienter"—"intent to deceive, manipulate, or defraud," *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193 n.12, 201 (1976)—and that the Rule does not reach ordinary breaches of contract or fiduciary duty or "prohibit any conduct not involving manipulation or deception." *Santa Fe Indus.* v. *Green*, 430 U.S. 462, 473 (1977).

In this putative class action, which challenges millions of small retail securities transactions with an aggregate value of many billions of dollars, the court of appeals has launched Rule 10b-5 on yet another judicially created mission to police conduct that is not fraud. The court—disagreeing with both the district court and the panel—ruled that a securities broker-dealer that makes no false statements, executes all transactions in accordance with

law, regulations, and SEC and National Association of Securities Dealers ("NASD") guidance, and conforms to virtually universal industry practice, may nevertheless violate Rule 10b-5 by failing to tell its customer that it will not take additional steps that a jury might later deem "reasonably available" to "maximize the economic benefit to the client in each transaction." Pet. App. 7a.

This sweeping decision, which conflicts with decisions of other courts of appeals, transforms Rule 10b-5 into a broad mandate for juries to find securities firms liable for federal securities fraud on the ground that they have not acted "reasonably" or have not done everything "feasible" to benefit their customers. The decision invites a proliferation of Rule 10b-5 suits challenging every aspect of broker-dealer conduct. Since such suits will turn on jury determinations of reasonableness and feasibility, they will be difficult to resolve on pretrial motions. This Court should review the Third Circuit's decision in order to restore certainty to an area of the law in which "clarity, consistency, and coherence" are essential. *Musick, Peeler & Garrett* v. *Employers Ins.*, 508 U.S. 286, 295 (1993).

The Over-the-Counter Securities Market

The over-the-counter ("OTC") equity market is a "dealer market" created by securities firms buying and selling stocks for their own accounts. Each dealer that "makes a market" in a particular stock stands continuously ready to buy at the firm's "bid" price or sell at its "offer" price. "By making known the price[s] at which they are willing to transact [purchases and sales] in a particular stock * * * market makers create a competitive structure in which fair prices are arrived at quickly and efficiently." Pet. App. 43a.[1]

[1] A dealer market like the NASDAQ market contrasts with an auction market, such as the New York Stock Exchange. At the NYSE, brokers carrying buy or sell orders for a security physically meet on the exchange floor at the post of a "specialist" who conducts a continuous auction.

These market makers are linked together by an electronic system created at congressional direction, called the NASD Automated Quotation System or "NASDAQ." See Securities Exchange Act of 1934 § 11A, 15 U.S.C. § 78k-1. Every aspect of the market is regulated by NASD rules, which must be approved by the SEC. See Securities Exchange Act § 19(b), 15 U.S.C. § 78s(b). More than 500 market maker firms, communicating by computer, display their "bid" and "offer" quotations in the NASDAQ-listed stocks in which they make markets.

As required by SEC regulations, the NASDAQ computer system receives all market makers' bid and offer quotations and continuously determines the highest bid quoted by any market maker and the lowest offer quoted by any market maker. See 17 C.F.R. § 240.11Ac1-1(b)(1)(ii). This continuously changing pair of quotations "has come to be known as the National Best Bid and Offer ('NBBO')." Pet. App. 44a.

Retail Customers and the Duty of Best Execution

When a retail customer calls a broker to place a buy or sell order, two different things can happen. If the firm makes a market in the stock, it may fill the order by selling from, or buying for, its own inventory. If the firm does not itself make a market, it will act as the customer's agent, communicating the order to a market making firm for execution.[2]

The customer's broker, whether it fills the order itself as principal or acts as the customer's agent, is subject to a fiduciary duty of "best execution." The district court stated that this duty has no single authoritative source and that "[n]o one is sure quite what best execution means in all circumstances." Pet. App. 72a. It said the duty "eludes definition." Pet. App. 68a.

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[2] Merrill Lynch and Dean Witter acted as market makers for named plaintiffs Zakheim and Kravitz respectively. PaineWebber acted only as agent for named plaintiff Binder. Pet. App. 56a.

Two important features of best execution are, however, clear. First, although *price* is an important element, it is not the only element, because a customer is also interested in speed and transaction costs. Accordingly, the SEC has stated that the broker should also take into account "order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market." Supplemental Brief of the Securities and Exchange Commission, Amicus Curiae (Nov. 21, 1997) at 5; see also Pet. App. 7a n.2. Second, in a dealer market, where a dealer is trading for its own account, sometimes with its customers, best execution must necessarily be defined by law, regulation, and industry custom. The dealer cannot have an unbounded obligation to maximize the customer's profit, because no firm would become a dealer—in securities or any other product—if it had no right to profit in transactions with its customers.

The Duty of Best Execution, the NBBO, and Dealer Profit

The NASD's Conduct Rules state that the dealer's fiduciary duty is discharged by

> us[ing] reasonable diligence to ascertain the best inter-dealer market for the subject security and buy-[ing] or sell[ing] in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.

NASD Manual (CCH), Rule 2320 (July 1997). At the time relevant to this case, the SEC staff, the NASD, and the industry believed that "the best inter-dealer market" was the NASDAQ, and that a broker-dealer discharged its fiduciary duty of best execution of small retail market orders by swiftly and routinely (i.e., electronically) buying or selling (or communicating the order to a market maker that would buy or sell) at the NBBO:

The SEC staff. In *Market 2000*, the most comprehensive SEC study of U.S. equity markets since the 1970s, the SEC staff concluded that "it is reasonable to accept

quote-based executions of market orders based on the NASDAQ best bid or offer [i.e., the NBBO] as consistent with best execution, absent customer instructions to the contrary." Division of Market Regulation, United States Securities and Exchange Commission, *Market 2000: An Examination of Current Equity Market Developments* ("*Market 2000*") at V-5, 1994 SEC LEXIS 136, at *15 (Jan. 1994). In this case, the SEC staff told the court of appeals in an amicus brief that it

> is not aware, and was not aware during the class period, of any alternative systems offering better prices that were reasonably available (such as by electronic linkages) during the class period for execution of small orders handled by broker-dealers in an automated order routing environment.

Supplemental Brief of the Securities and Exchange Commission, Amicus Curiae (Nov. 21, 1997) at 6-7. After the class period, the SEC reaffirmed that NBBO executions have "long been viewed as satisfying best execution obligations." Order Execution Obligations, Exchange Act Release No. 34-36310, 60 Fed. Reg. 52,792 (Sept. 29, 1995).

The NASD. The NASD's General Counsel told the district court in this case that

> [t]he NASD has viewed [execution at the NBBO] as consistent with the duty of "best execution" that broker-dealers assume when they accept customer orders. * * * The NASD has not in the past adopted any rules that required market makers to "cross" market orders with in-house limit orders rather than execute those orders at the NBBO. The NASD also has not required market makers to seek execution of market orders at prices reflected in the Instinet or Selectnet system.

Pet. App. 50a (bracketed material inserted by the court). Indeed, the NASD designed, and the SEC approved, a small order execution system, or "SOES," in which it required market makers to participate, which automatically

executed small orders at the NBBO without human intervention or searches for alternative sources of liquidity.[3]

The industry. Execution of small orders at the NBBO was virtually universal industry practice. Former SEC Chairman David S. Ruder told the district court that:

> [i]t has long been the understanding in the securities industry that investors receive best execution when their small OTC orders are executed at the NBBO. It is the general custom and practice of firms in the industry to execute such orders at the NBBO.

Pet. App. 50a-51a. Accordingly, the district court found and the court of appeals acknowledged that,

> [i]t is undisputed that defendants' reliance on NBBO prices when executing small orders is widely, if not almost universally followed with respect to OTC securities. That this is the practice is fully known in the industry. It is no secret.

Pet. App. 74a; see also Pet. App. 15a.

Routine execution of market orders at the NBBO enables dealers who make markets to profit on the "spread" between the NBBO best bid and best offer. Pet. App. 43a, 3a. To take a simple example, suppose that at a given moment the NBBO on XYZ shares is 12 bid, 12¼ offered. A market maker that receives a customer order to sell 100 XYZ shares "at the market" may fill the order by buying the shares from the customer at the NBBO bid of 12. If, moments later, the firm receives a customer order to buy 100 XYZ shares "at the market," the firm may (unless the NBBO "offer" has changed in the interim) fill that order by selling 100 shares at 12¼. The ¼ profit represents a return for the market-maker's commitment of capital, and is a fundamental feature of the over-the-counter dealer market. Pet. App. 43a.[4]

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[3] For a description of SOES, see Small Order Execution System, Exchange Act Release No. 34-33377, 58 Fed. Reg. 69,419, 69,420 (Dec. 23, 1993).

[4] The SEC's Division of Market Regulation has observed that the duty of best execution differs, depending on whether the security

Respondents' Claims

Respondents are retail customers who bought or sold NASDAQ-listed stocks between November 4, 1992, and November 4, 1994 (the "class period"). They brought this case as a class action, alleging that petitioners violated Section 10(b) and Rule 10b-5 in connection with the execution of small orders to buy or sell NASDAQ-listed stocks "at the market." They sought an accounting of profits and other compensation received by petitioners on all such transactions (according to the complaint, tens of thousands of transactions daily by each petitioner, see Pet. App. 61a).

Respondents claimed that petitioners had a duty to seek "alternative sources of liquidity" that allegedly might produce better-than-NBBO prices for small retail transactions. Specifically, respondents claimed that petitioners should have executed orders by using "Instinet" or "SelectNet," or by "crossing" respondents' orders with other in-house orders when doing so would have resulted in better prices. Respondents asserted that petitioners' failure to seek better prices by using these alternative methods of execution (or to state affirmatively that they would not do so) violated Rule 10b-5.

Instinet is a private corporation that provides a proprietary system designed to enable subscriber institutions to display anonymous bids and offers to each other. It is not a market maker (that is, it has no obligation to and does not continuously maintain a bid and an offer on any security) but it is a potential source of buy and sell orders. See Pet. App. 45a; Instinet Corp., SEC No-Action Letter,

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is traded in an auction market like the NYSE or a dealer market like NASDAQ, because "with respect to NASDAQ stocks * * * the over-the-counter ('OTC') market is structurally different from the exchange market. It relies on dispersed, competing dealers rather than order interaction." *Market 2000* at V-5, 1994 SEC LEXIS 136, at *15.

1992 WL 672345, at *2 (Jan. 15, 1992); Instinet Corp., SEC No-Action Letter, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,997, at 78,924, 1986 WL 67657, at *13 (Sept. 8, 1986). SelectNet is a communications feature enabling NASDAQ market makers to transmit orders through their NASDAQ terminals rather than by telephone. SelectNet also is not a market-maker: a SelectNet transmittal is a proposal from one dealer to another to engage in a specific transaction in a specific security at a specific price. Pet. App. 44a-45a, 84a. During the class period, Instinet and SelectNet bids and offers were not required to be reflected in the NBBO.[5]

Respondents' other alleged "alternative source of liquidity" was crossed orders. They contended that if a broker-dealer received a market order to buy 100 shares and had another order to sell 100 shares, it had a duty to "cross" them, rather than fill both orders itself and earn a spread. In the class period, no SEC or NASD rule or industry practice required such crossing.[6]

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[5] The duty of best execution has evolved with technological improvements and growth in volume. Before NASDAQ, broker-dealers were expected simply to make three telephone calls to obtain quotations. See Order Execution Obligations, Exchange Act Release No. 34-36310, 60 Fed. Reg. 52,792, 52,793 (Sept. 29, 1995). When NASDAQ made all market makers' quotes available on a screen, regulators required dealers to consider all such quotes. See American Stock Exchange, Inc., Exchange Act Release No. 16518, 45 Fed. Reg. 6521 (Jan. 22, 1980).

Nearly two years after the class period, the SEC adopted new order execution rules requiring market makers to incorporate their offers to sell or buy through alternative channels such as Instinet and SelectNet into their quotations on NASDAQ, so that they can be reflected in the NBBO. Order Execution Obligations, Exchange Act Release No. 34-37619A, 61 Fed. Reg. 48,290, 48,290-91 (Sept. 12, 1996). Thus, the SEC expanded the content of the NBBO. Notably, it did not require firms to search, on an order-by-order basis, for better prices *outside* the NASDAQ system. See Pet. App. 62a, 77a.

[6] On the contrary, during the class period, the NASD *expressly* permitted the firm to execute a market order at the NBBO, and

Respondents' Rule 10b-5 complaint challenged petitioners' conduct in executing market orders both as principals and as agents. It asserted that, when acting as principals, petitioners improperly executed trades with their customers at the NBBO when better prices were available from Instinet and SelectNet, and improperly failed to cross respondents' orders with other in-house orders. The district court construed the complaint to assert that, when acting as agents, petitioners improperly transmitted orders to market makers who relied exclusively on the NBBO.

Petitioners moved for dismissal on the ground that automatic executions at the NBBO discharged the duty of best execution as stated by the SEC and NASD and as understood throughout the industry. In addition, petitioners contended that respondents could not prove scienter—"a mental state embracing intent to deceive, manipulate, or defraud," *Hochfelder*, 425 U.S. at 193 n.12—because petitioners acted in accordance with regulatory guidance and industry standards. Petitioners also contended that respondents could not establish deception or concealment because respondents made no misrepresentations and the fact that small retail market orders were routinely executed at the NBBO price was publicly known.

The District Court's Ruling

The district court converted petitioners' motion to one for summary judgment and granted the motion. The court found that "[i]t is undisputed that defendants' reliance on NBBO prices when executing small orders is widely, if not almost universally followed with respect to OTC securities. That this is the practice is fully known in the industry. It is no secret." Pet. App. 74a. The court concluded that petitioners' conduct therefore could not be found deliber-

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earn a spread, even when the firm might instead have crossed the order with an existing limit order. See *E.F. Hutton*, 49 S.E.C. 829 (1988); Special NASD Notice to Members 95-43 at 308 (first question) (June 5, 1995).

ately deceptive: "[Petitioners] cannot have misrepresented material facts by following existing practices and * * * cannot have acted with scienter." Pet. App. 78a.

The district court also gave weight to the practical need to execute small orders at the NBBO:

> [T]he additional inquiries which would have to be made when executing each defendant's tens of thousands of daily relatively small orders might be so time consuming and burdensome that customers would be prejudiced through the inability of broker/dealers to execute customer orders in a timely and inexpensive manner.

Pet. App. 62a. The court added, "It may well be that in any given transaction inquiry of all relevant markets and pending orders might produce a price superior to the NBBO price, but it may not constitute best execution in that transaction because of delay and it may not constitute best execution generally because were the practice followed in all transactions the interests of all customers in an inexpensive and efficient market might be impaired." Pet. App. 69a-70a.[7]

Finally, the district court noted that the SEC had played an active role in defining broker-dealers' obligations and that this task should be left to the agency. The "issues which plaintiffs raise have [since] been and are being specifically addressed by the SEC and NASD" (Pet. App. 76a) including through "proposed regulations [that] are prospective only" and require that the "NBBO should reflect [some additional price quotations] and that some retail limit and market orders should be crossed." Pet. App. at 77a. The court therefore concluded:

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[7] The court's view of the importance of highly efficient electronic executions was correct. From 1985 to 1995, NASDAQ share volume increased 389% to more than 400 million shares traded daily, and dollar volume increased 906% to $2.4 trillion. NASD Manual 157 (CCH) (July 1997). This increase was accomplished without problems of delay in executions or reporting.

> These regulatory developments confirm that defendants cannot have misrepresented material facts by following existing practices and cannot have acted with scienter when only now the regulatory agencies are exploring and adopting regulations designed to meet a continually evolving market. * * * Plaintiffs are effectively asking the court to retroactively second-guess the SEC. While the comprehensive scheme devised by Congress to regulate the securities industry may itself be ripe for reform, the judiciary should not be used as a method to bypass that scheme.

Pet. App. at 78a (footnote omitted).

The Third Circuit's Rulings

On appeal, a panel of the Third Circuit affirmed, holding that respondents could not prove scienter (Pet. App. 25a):

> [W]here defendants are under no affirmative legal duty to disclose their order execution practices and those practices are widely followed within the securities industry, as a matter of law there is no scienter when defendants fail to disclose those practices.

On rehearing en banc, the Third Circuit reversed and remanded for trial. The court relied on the "shingle theory": the theory that securities professionals, by offering their services, make certain implied representations to clients. See *Arleen W. Hughes*, 27 S.E.C. 629 (1948). The court held that broker-dealers make an "implied representation" that they will "maximize the [customer's] economic benefit" (Pet. App. 6a-7a), and that "a reasonable trier of fact could conclude" that petitioners "intended not to act in a manner consistent with [this implied representation]." Pet. App. 16a, 12a.

The en banc court followed what it described as a "chain of inferences." Pet. App. 13a. It said that "by accepting an order," a firm "impliedly represents that the

order will be executed in a manner consistent with the duty of best execution." Pet. App. 5a. It then interpreted this duty as requiring the firm "to use reasonable efforts to maximize the economic benefit to the client in each transaction." Pet. App. 7a. Maximizing the client's economic benefit, the court said, means that if better prices were "*reasonably available*," because it was "*feasible* for the [petitioners] to execute trades through SelectNet and Instinet when prices more favorable than the NBBO were being quoted there," petitioners had a duty to execute orders at those better prices. Pet. App. 6a (emphasis added). The court concluded that if a jury could find that it was feasible to execute transactions at prices more favorable than the NBBO, then petitioners' "implied representation * * * that they intended to maximize the plaintiffs' economic gain in the transaction" was false. Pet. App. 12a.

The court noted that "execution of customer orders at the NBBO was a practice widely, if not almost universally followed in the securities industry during the class period," but dismissed this fact because "[e]ven a universal industry practice may still be fraudulent." The court acknowledged, however, that "the practice of exclusive reliance on the NBBO has never been held to be fraudulent by any court or regulator." Pet. App. 15a. The court did not explain how an implied representation that a firm would discharge its duty of best execution could be rendered fraudulent at the time it was made by the court's later unprecedented interpretation of that duty and a jury's hindsight view of what securities transactions would have been "reasonably available" or "feasible." The court also did not explain how its decision could be reconciled with *Hochfelder*'s scienter requirement or *Santa Fe*'s teaching that breaches of duty or contract, not involving fraud, do not violate Rule 10b-5.

REASONS FOR GRANTING THE PETITION

The Third Circuit's decision conflicts with decisions of this Court and other circuits that have limited Rule 10b-5 to cases involving scienter and actual fraud. The decision eviscerates the scienter requirement, in cases involving broker-dealers, by positing a "representation" that the firm will take every step a jury later determines was "reasonably available," even steps that would have been at odds with SEC and NASD guidance and virtually universal industry practice. The decision also clashes with the principle that Rule 10b-5 catches only fraud, turning the Rule into an open-ended source of federal common law to police the "reasonableness" or "prudence" of broker-dealer practices. Underpinning the Third Circuit's ruling is the mistaken idea that a broker-dealer's "shingle" contains an implicit representation that the firm will do *more* than fully comply with law and trade custom.

The questions presented are of profound importance to the securities industry. This action against three leading broker-dealers itself involves millions of transactions worth billions of dollars. If the decision below stands, many similar cases are certain to follow, since virtually all broker-dealers routinely executed small orders at the NBBO. But the Third Circuit's ruling is not limited to a past period or to matters of price: if that court is right, imaginative plaintiffs and counsel can bring a flood of Rule 10b-5 suits against securities firms, alleging that they have not immediately adapted to "changes in technology and markets" and in this way or otherwise have failed to take all "feasible" measures to "maximize the economic benefit to the client."

I. THE DECISION BELOW CONFLICTS WITH DECISIONS OF THIS COURT AND OTHER COURTS OF APPEALS.

A. The Third Circuit's Decision Is Inconsistent With *Hochfelder*'s Scienter Requirement and With Decisions of Other Courts of Appeals Interpreting That Requirement.

In *Hochfelder*, this Court held that, particularly in view of its statutory provenance, Rule 10b-5 applies only to conduct involving "scienter," which the Court defined as "a mental state embracing intent to deceive, manipulate, or defraud." 425 U.S. at 193 n.12. "It is not enough" that a broker's conduct allegedly "results in harm to investors; rather, a violation may be found only where there is 'intentional or willful conduct designed to deceive or defraud investors.'" *Dirks*, 463 U.S. at 663 n.23 (quoting *Hochfelder*, 425 U.S. at 199).

The court of appeals did not suggest that petitioners made a false or misleading statement. Pet. App. 6a, 12a. According to the court, (i) petitioners made an "implied" representation that they would offer best execution, (ii) this implied representation included a further implied representation that petitioners would seek out any reasonably "feasible" source of liquidity so as to "maximize [respondents'] economic benefit from the trade" (Pet. App. 6a, 10a), and (iii) a jury could find that this implied representation was false and "that this misrepresentation was intentional or reckless because, at the time it was made, [petitioners] knew that they intended to execute [respondents'] orders at the NBBO price." Pet. App. 16a. Thus, petitioners may be liable for securities fraud if a jury attributes to them a purely constructive "intent" not to conform to a wholly fictitious "representation."

The court of appeals has attempted "to leap a chasm in two bounds." [8] The question, under *Hochfelder*, is whether

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[8] *City of New York* v. *Clinton*, 985 F. Supp. 168, 181 (D.D.C. 1998) (quoting Benjamin Disraeli).

petitioners "intend to deceive, manipulate, or defraud" their customers, and the answer to that question is inescapably "no." At the time petitioners accepted respondents' orders and allegedly made their implied representation that they would seek "best execution," no one had asserted that "best execution" implied a general obligation to "maximize [the customer's] economic benefit" through any "reasonable" or "feasible" means. On the contrary, the SEC, NASD, and industry understanding was that "best execution" of small orders meant swift and routine (indeed, automatic electronic) execution at the NBBO; "profit maximization" in any "feasible" manner was the Third Circuit's own invention. There is simply no basis for charging petitioners with fraud for failing to disclaim, at the time, an intention to take steps that the SEC did not—even two years later (see n.5, *supra*)—require in connection with order executions, and which the Third Circuit has crafted for the first time *now*. Even if respondents could show that the SEC, the NASD, and the rest of the industry were wrong in their assessment of the duty of best execution, and that petitioners were negligent in relying on them, they would not have demonstrated an intent to deceive, manipulate, or defraud.[9]

The decision below is in sharp conflict with decisions of other courts of appeals interpreting *Hochfelder*'s scienter requirement. In *Platsis* v. *E.F. Hutton & Co.*, 946 F.2d 38, 40-41 (6th Cir. 1991), the Sixth Circuit held that a broker's failure to disclose to its customers certain forms of compensation that the broker received (production credits, spreads, and markups) did not violate Rule 10b-5.

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[9] In support of its view that even a universal industry practice may be fraudulent (Pet. App. 15a), the Third Circuit cited *Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). But *Chasins* cannot be reconciled with this Court's later decision in *Hochfelder* because scienter was neither required nor found. And it is inconsistent with *Dirks* and *Chiarella*, because, as Judge Friendly pointed out in his dissent for three Judges from the denial of rehearing en banc, "[t]he complaint nowhere asserted that Smith Barney was under a duty to [disclose the information at issue]."

Reversing a securities fraud verdict for plaintiffs, the Sixth Circuit ruled that a mere omission cannot constitute intentional deception in the absence of an established regulatory duty to disclose. The broker's omission was in some sense intentional, but the Sixth Circuit held that there was no scienter, no intent to deceive: "Since very few brokers disclosed these credits at the time these events took place and there was no established regulatory duty to disclose these items, an intent to deceive * * * could not be established merely by the omission of this information in the absence of special circumstances." *Id.* at 41. The Sixth Circuit therefore would have reached a different result than the Third Circuit in this case, where petitioners acted in conformity with regulatory guidance and general industry practice.

The Fifth Circuit would also have decided this case differently, as demonstrated by its ruling in *Shivangi* v. *Dean Witter Reynolds, Inc.*, 825 F.2d 885 (5th Cir. 1987). There, the court of appeals affirmed the dismissal of a customer's claim that a brokerage firm violated Rule 10b-5 when it failed to disclose that an account executive received a higher commission for a transaction in which the firm acted as a principal than for a transaction in which it acted as an agent. Under *Hochfelder*, this omission involved no scienter because "[a]t the time of the [plaintiff's] purchase, neither the SEC nor any court had determined the compensation information to be material," and there was no indication that "compensation to sales personnel is ordinarily disclosed in the securities industry, a fact that might have indicated to Dean Witter the danger of nondisclosure." *Id.* at 889.

Other courts of appeals would also reject securities fraud claims in a case like this one where a firm followed regulatory guidance and industry practice. The Eleventh Circuit, in *Messer* v. *E.F. Hutton & Co.*, 847 F.2d 673, 678-679 (11th Cir. 1987), held that a firm lacked scienter when it made trades to straddle the plaintiff's futures, which were falling in value, because "straddling an invest-

ment is a common and accepted industry practice to protect an account against extreme losses." See also *Banca Cremi* v. *Alex. Brown & Sons,* 132 F.3d 1017, 1037 n.26 (4th Cir. 1997) (plaintiffs would have a "heavy burden" in proving scienter in the face of "the defendants' adherence to an industry-wide guideline").

The Eleventh Circuit has also rejected the Third Circuit's view that, under *Hochfelder,* a firm acts with scienter if it fails to do something that a fact-finder subsequently determines was "reasonable" or "feasible." See *McDonald* v. *Alan Bush Brokerage Co.,* 863 F.2d 809, 815 (11th Cir. 1989) ("unreasonableness does not meet the standard for scienter"; proving that a broker-dealer's conduct was "not appropriate or reasonable * * * may establish negligence, but it clearly falls far short of demonstrating [intent] or recklessness").

In short, the Third Circuit's ruling is at odds with this Court's scienter decisions and settled scienter law in other Circuits, and plainly warrants review.

B. The Third Circuit's Decision Is Inconsistent With Decisions of This Court and Other Courts of Appeals Holding That Rule 10b-5 Prohibits Only Manipulative or Deceptive Conduct.

Rule 10b-5 is based on a statute, Section 10(b), that bars "manipulative or deceptive device[s] or contrivance[s]." Accordingly, this Court has confined the Rule to fraudulent conduct, rejecting attempts to extend it to other forms of misconduct having some connection to transactions in securities. In *Santa Fe,* the Court rejected a Rule 10b-5 claim by minority stockholders who asserted that they had been improperly frozen out by a short-form merger at a grossly inadequate price. The Court noted that the plaintiffs might have a state-law remedy, 430 U.S. at 478, but ruled they had no Rule 10b-5 claim because "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipu-

lation or deception." *Id.* at 473. The Rule does not cover claims of mismanagement "in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary." *Id.* at 477. To allow a Rule 10b-5 claim to be based on allegations of breach of fiduciary duty, even when characterized as "fraud in the equitable sense," would "pos[e] a 'danger of vexatious litigation' " and "interfere with" state law "fiduciary standards." *Id.* at 471 & n.11, 478-479 (quoting *Blue Chip Stamps*, 421 U.S. at 740). See *Schreiber* v. *Burlington N., Inc.*, 472 U.S. 1, 12 (1985) (reaffirming the *Santa Fe* principle in the context of the parallel antifraud provision in Section 14(e) of the Williams Act).

The essence of the present case, like *Santa Fe* and *Schreiber*, is a claimed breach of fiduciary duty: respondents claim (and petitioners vigorously deny) that petitioners did not handle respondents' orders in a manner that was reasonably diligent. The Third Circuit would have the jury determine whether better prices were "*reasonably available*" because "it was *feasible* for the defendants to execute trades through SelectNet and Instinet when prices more favorable than the NBBO were being quoted there." Pet. App. 6a. But the fact that a broker-dealer did not do all that was "reasonable" and "feasible" to maximize its client's return cannot conceivably be a proper basis for Rule 10b-5 liability under *Santa Fe* and *Schreiber*, which require *fraud*.

Nor can there be any serious claim of manipulation or deception here. Routine execution of small market orders at the NBBO was described in official and other literature, see pp. 5-7, *supra*, was virtually universal practice in the securities industry, and was "no secret." Pet. App. at 74a, 15a. The federal securities laws impose " 'no duty to disclose information to one who reasonably should already be aware of it,' " *Seibert* v. *Sperry Rand Corp.*, 586 F.2d 949, 952 (2d Cir. 1978) (quoting *Myzel* v. *Fields*, 386

F.2d 718, 736 (8th Cir. 1967)),[10] and the complaint does not allege that respondents were in fact uninformed about how their orders would be executed, or that they *behaved* in some way different from what they would otherwise have done. See *Santa Fe*, 430 U.S. at 474 n.14 ("respondents do not indicate how they might have acted differently had they had prior notice"). To be sure, respondents here artfully alleged that petitioners' conduct was not only wrongful but deceptive because petitioners failed to announce it in advance. But that kind of "nondisclosure" allegation could be tacked on to virtually any claim of breach of fiduciary duty, bootstrapping it into a claim of fraud and circumventing the principles set forth in *Santa Fe*. See *Chiarella*, 445 U.S. at 232 ("financial unfairness" claims cannot be bootstrapped into "fraud").

Other courts of appeals have routinely rejected, as inconsistent with *Santa Fe*, the theory that alleged breaches of fiduciary duty by a broker-dealer can be transmuted into fraud and brought within Rule 10b-5 by asserting that the dealer "impliedly represented" that it would do its duty. For example, in *Forkin* v. *Rooney Pace, Inc.*, 804 F.2d 1047, 1050 (8th Cir. 1986), plaintiffs claimed that a broker violated Rule 10b-5 when it rescinded a sale of securities to plaintiffs, alleging that in doing so the broker breached an implied "representation of fair dealing." The Eighth Circuit rejected this claim on the ground that "whatever representations may be implicated in the broker-investor relationship," Congress did not intend Section 10(b) to reach "every imaginable breach of fiduciary duty." The court of appeals explained that under a contrary interpretation, "every instance of broker misconduct

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[10] See also, *e.g.*, *Acme Propane, Inc.* v. *Tenexco, Inc.*, 844 F.2d 1317, 1323-1324 (7th Cir. 1988) ("The securities laws require the disclosure of information that is otherwise not in the public domain"); *Whirlpool Fin. Corp.* v. *GN Holdings*, 67 F.3d 605, 609 (7th Cir. 1995).

would give rise to a cause of action under the anti-fraud provisions of the federal securities laws." *Ibid.*

Similarly, in *Banca Cremi*, 132 F.3d at 1035, the Fourth Circuit declined to adopt a theory under which "securities dealers have an inferred duty to disclose certain markups" on sales of securities though the SEC did not require them to do so, and "[d]issatisfied customers who feel that an undisclosed markup is excessive * * * may bring a private cause of action for fraud based on a dealer's failure to meet this inferred duty to disclose." Other circuits have repeatedly rejected fiduciary claims masquerading as securities fraud allegations. See *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971) (claim based on an alleged oral agreement not to liquidate an account "is nothing more than a garden-variety customer's suit against a broker for breach of contract, which cannot be bootstrapped into an alleged violation of § 10(b)"); *Zerman* v. *Jacobs*, 510 F. Supp. 132, 134 (S.D.N.Y.), aff'd mem., 672 F.2d 901 (2d Cir. 1981) (same); *Pross* v. *Baird, Patrick & Co.*, 585 F. Supp. 1456, 1460 (S.D.N.Y. 1984) (holding that broker trades contrary to express client instructions, while "reprehensible," at most provided "the basis for a claim of breach of fiduciary duty or breach of contract"); *Wassel* v. *A.G. Edwards & Sons*, 425 F. Supp. 1205, 1207 (D. Md. 1977) (unauthorized trades might give rise to a tort or contract claim, but they involved no misrepresentation and could not support a fraud claim).

This Court should grant certiorari to resolve this conflict on an important and recurring issue of federal securities law.

C. The Third Circuit's Decision Rests on a Construction of the "Shingle Theory" at Odds With Settled Law.

The theory that a broker-dealer, by "hanging out its shingle," makes implied representations about how it will act on a customer's behalf is known as the "shingle

theory." The Third Circuit had this theory in mind when it invented an implied representation by broker-dealers that they will take all feasible steps to maximize a client's economic benefit. As the district court recognized, there is no other source for such a representation: "Plaintiffs' allegations here are premised solely on the general nature of the relationship between the parties and make no effort to particularize any misrepresentations." Pet. App. 71a n.11. The court of appeals found support for this new duty in the SEC's 1948 *Arleen W. Hughes* decision, the leading shingle theory case. Pet. App. 7a; see 4 Bromberg & Lowenfels, *Securities Fraud and Commodities Fraud*, at 15:157-15:158 (1997); Jaffe, *Broker-Dealers and Securities Markets* 145-147 (1978). But if the "shingle theory" remains valid at all, the Third Circuit has expanded it beyond recognition.[11]

The established understanding of the shingle theory is that "a broker-dealer, by hanging out his shingle, impliedly represents that he will deal fairly with his customers *in accordance with the standards and practices of the profession*." 4 Bromberg & Lowenfels, *supra*, at 15:158 (emphasis added). See, *e.g.*, *Duker & Duker*, 6 S.E.C. 386, 388 (1939) (implying a representation that the broker-dealer will act "in accordance with the standards of the profession"); *Banca Cremi*, 132 F.3d at 1034 (same); Jaffe, *supra*, at 145 (under the shingle theory, a broker impliedly represents that it will act "in the usual manner and in accordance with trade custom"); Wolfson, Phillips & Russo, *Regulation of Brokers, Dealers, and Securities Markets* § 2.10, at 2-51 (1977) (the shingle

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[11] This Court's decisions "rais[e] questions as to the continuing validity of the 'shingle theory' for broker-dealers." 4 Bromberg & Lowenfels, *supra*, at 5:158. Former SEC Commissioner Roberta Karmel has argued persuasively that after *Santa Fe* and other cases, "the shingle theory is no longer a sound basis for civil liability to private parties under the antifraud provisions." Karmel, *Is the Shingle Theory Dead?*, 52 Wash. & Lee L. Rev. 1271, 1272-1273, 1296 (1995).

theory's implied representation is measured by "the standards of the industry"). As Roberta Karmel has explained, shingle theory standards are based on "industry principles of custom and usage." Karmel, *supra*, at 1275.[12]

The Third Circuit's ruling conflicts with this established understanding and these cases. The court below created an implied representation that a firm would maximize the client's economic benefit by seeking out better prices whenever it was "feasible" to do so. Such a representation is inconsistent with "trade custom," under which the SEC and NASD permitted (indeed, through SOES encouraged) broker-dealers to execute small orders automatically at the NBBO, and nearly every broker-dealer did so. See *supra*, pp. 5-7. In jettisoning the accepted limits of the shingle theory—a theory that even in its traditional form is in tension with this Court's Section 10(b) jurisprudence—the Third Circuit has made a complete end run around *Santa Fe* and *Hochfelder*.

II. IF LEFT UNREVIEWED, THE DECISION BELOW WILL HAVE EXCEPTIONALLY IMPORTANT CONSEQUENCES FOR SECURITIES LITIGATION AND REGULATION.

This case is important in and of itself. Respondents purport to represent a class consisting of "all those persons who placed market orders" with petitioners during a two-year period. They allege that each defendant "*daily* took *tens of thousands* of relatively small orders [covered by the complaint] * * * to buy and sell *tens of millions* of shares of stock." Complaint ¶ 25 (emphasis added). Their discovery requests cover transactions with an estimated value of *$2.7 trillion*. And if the decision below

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[12] Respondents agreed that their transactions would be effected in accordance with the custom and usages of the markets in which those transactions occurred. Confirmation slips typically recited "[t]hat all transactions are subject to the * * * customs [and] usages * * * of the exchange or market * * * where the transactions are executed." Quigley Supp. Decl. Ex. C.

stands, similar claims against every major retail broker-dealer are sure to follow, because the practices challenged were virtually universal.

Even more important, as the Court said in *Santa Fe*, "[t]he reasoning behind a holding that the complaint in this case alleged fraud under Rule 10b-5 could not be easily contained." 430 U.S. at 478. Every broker-dealer has general duties in dealing with its customers, including a "duty of best execution" and a "duty of fair dealing." See, *e.g.*, *Rooney Pace*, 804 F.2d at 1050. If broker-dealers are deemed to make an implied "representation" that they will perform those duties, and judges and juries, by later deciding what is "reasonable," "feasible" and "fair," may give content not only to those duties but also to the implied representation, then customers can sue broker-dealers under Rule 10b-5 for virtually any action or inaction they choose to challenge. *Every* step taken, or not taken, in determining price and executing a customer's order could be challenged not only as a breach of the duty of best execution or fair dealing but also as falsifying the defendant's representations and hence violating Rule 10b-5. As the Eighth Circuit recognized in *Rooney Pace*, that would mean that "every instance of broker-dealer misconduct would give rise to a [Rule 10b-5] cause of action"—and every instance of *alleged* misconduct could be pursued with the federal machinery of Rule 10b-5. *Ibid.*[13]

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[13] Different customers could easily allege conflicting implied misrepresentations. In this case, the Third Circuit held that a broker-dealer impliedly "represents" that it will *not* rely on swift, routine execution on NASDAQ at the NBBO when some alternative source of liquidity might be "feasible," as later determined by a jury. But a broker-dealer that spends extra minutes searching for an alternative and *loses* the best price because the market moves away while it is looking could be sued under Rule 10b-5 for "misrepresenting" that it would act swiftly. Both claims could be presented in class actions that require sorting through millions of transactions to determine whether they have any factual merit at all.

For example, the broker-dealer's duty of fair dealing includes duties not to recommend a security without an adequate basis for doing so and not to recommend an investment that is unsuitable for the client. 4 Bromberg & Lowenfels, *supra*, at 15:164-15:167. Under *Santa Fe*, alleged breaches of these duties have not been regarded as a target of the antifraud rules. *E.g.*, Loss & Seligman, *Fundamentals of Securities Regulation* 900 (1995); *McDonald*, 863 F.2d at 815; *Utah State Univ. of Agric. & Applied Sciences* v. *Bear, Stearns & Co.*, 549 F.2d 164, 168-169 (10th Cir. 1977). Now, however, the Third Circuit's decision invites a dissatisfied customer to bring a Rule 10b-5 action alleging that the broker-dealer did not do all that was feasible to research a recommended security (did not use, for instance, the most up to date technology to conduct its research) or did not take all reasonable steps to ensure that a security was suitable for the customer's portfolio.

Opening up all broker-dealer conduct to jury review under Rule 10b-5 will disserve both firms and their customers. This is an area that " 'demands certainty and predictability.' " *Central Bank*, 511 U.S. at 188 (quoting *Pinter* v. *Dahl*, 486 U.S. 622, 652 (1988)). Liability rules " 'offering little predictive value' " must be avoided. *Ibid.* Securities professionals need "guidance as to where the line is" between permissible conduct and securities fraud. *Dirks*, 463 U.S. at 658 n.17. Yet the Third Circuit has invented a rule that, because it depends on a jury's post-hoc view of what was reasonable or feasible, is "inherently imprecise" and "prevents parties from ordering their actions in accord with legal requirements." *Ibid.* See *Virginia Bankshares* v. *Sandberg*, 501 U.S. 1083, 1106 (1991) (rejecting expansive fraud theories that would lead to "hazy" issues, "protracted" litigation, and "unreliable" rulings).

Since disputes under the Third Circuit's new theory will turn on judgments about "reasonableness," they will also be difficult to resolve on pretrial motions. As this Court

explained in *Blue Chip Stamps*, "in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value * * * out of any proportion to its prospect of success," if only the plaintiff can survive pre-trial motions. 421 U.S. at 740, 742. The court of appeals' ruling invites the sorts of claims, "brought solely for their potential settlement value," that led this Court to reject expansive interpretations of Rule 10b-5 in *Hochfelder*, 425 U.S. at 210 n.30, and *Blue Chip Stamps*. These practical effects are magnified by the liberal venue provisions of the federal securities laws (15 U.S.C. § 78aa), which make it easy for class action litigants to file suit in the Third Circuit.

The Third Circuit's ruling also ignores the role of expert administrative oversight of public securities markets. See *United States* v. *NASD*, 422 U.S. 694, 729 (1975) (even expressly conferred judicial remedies should not be allowed to undermine SEC supervision); *Marine Bank* v. *Weaver*, 455 U.S. 551, 558-559 (1982); *International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. 551, 569-570 (1979) (implied remedies under the securities laws should not be expansively construed to conflict with administrative oversight). As the district court recognized, the SEC and NASD have the expertise to respond to changing market and technological conditions, and this is not a necessary or proper role for the courts applying the general fraud prohibition of Rule 10b-5. Pet. App. 75a-79a.

Finally, the interlocutory posture of this case presents no barrier to this Court's review. Immediate review would settle the important questions presented and resolve conflicts between the ruling below and decisions of this Court and of other courts of appeals, "promot[ing] clarity, consistency, and coherence for those who rely upon or are subject to, 10b-5 liability." *Musick, Peeler*, 508 U.S. at

295. In securities cases arising under Rule 10b-5, this Court has frequently granted interlocutory review at the stage when a court of appeals has remanded a case for further proceedings. *E.g., Central Bank*, 511 U.S. 164; *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350 (1991); *Basic, Inc.* v. *Levinson*, 485 U.S. 224 (1988); *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299 (1985); *Marine Bank*, 455 U.S. 551 (1982); *Santa Fe*, 430 U.S. 462; *Hochfelder*, 425 U.S. 185; *Blue Chip Stamps*, 421 U.S. 723. Because such cases pose a special "danger of vexatious litigation" and have an unwarranted settlement value (see *Blue Chip Stamps*, 421 U.S. at 740; p. 26, *supra*) this Court has not hesitated to grant review in this procedural posture.

Respondents have sought discovery with respect to every trade over a two-year period in the second largest stock market in the world. As a member of the Third Circuit panel observed, "You are going to be downstairs trying [this] case if it goes back for years." Tr. of Oral Argument at 9 (Oct. 24, 1996). The district court and panel believed that this case could be resolved based on petitioners' summary judgment motion, so immediate review of the denial of that motion could bring this immensely burdensome action to an efficient end. See *Celotex Corp.* v. *Catrett*, 477 U.S. 317, 327 (1986).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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